

1996

(REV. 1996)

STATE OF HAWAII—DEPARTMENT OF TAXATION

INSTRUCTIONS FOR FORM N-40 AND SCHEDULES A, B, C, D, E, J, K-1, AND T

FIDUCIARY INCOME TAX RETURN

(References are to the Internal Revenue Code (IRC), as adopted and incorporated by reference in Chapter 235, HRS, and the Department of Taxation Rules, and Publication references are to federal Publications)

WORLD WIDE WEB

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<http://www.hawaii.gov/icsd/tax/tax.html>

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GENERAL INSTRUCTIONS

A. Who must use Form N-40.—This form will be used by both resident and nonresident estates and trusts. A return shall be filed by:

- (1) Every estate having for the taxable year gross income of \$400 or more subject to taxation under the Hawaii Income Tax Law;
- (2) Every trust having for the taxable year any taxable income, or having gross income of \$400 or more subject to taxation under Hawaii Income Tax Law regardless of the amount of taxable income;
- (3) Every nonresident estate or trust having gross income of \$400 or more (some part or all of which is from sources within Hawaii) regardless of the amount of gross income subject to taxation or the amount of taxable income, (i) if any of the beneficiaries is a resident of Hawaii, or (ii) if in the case of a trust, a resident of Hawaii is treated as the substantial owner of any portion of the trust.

A beneficiary of an estate or trust, or person treated as the owner of any portion of a trust, who is taxable upon income thereof under the IRC, shall be taxed thereon as herein provided, irrespective of the taxability of the estate or trust or whether it is required to make a fiduciary return under this chapter. If all such income consists of income which would be taxable under this chapter if received directly by the beneficiary or person, the beneficiary or person shall be taxed upon all of it.

Note: Form N-40 for 1996 may also be used if: (1) the trust or estate has a tax year of less than 12 months that begins and ends in 1997 and (2) the 1997 Form N-40 is not available by the time the trust or estate is required to file its return. However, the trust or estate must show its 1997 tax year on the 1996 Form N-40 and incorporate any tax law changes that are effective for tax years beginning after December 31, 1996.

B. When and where Form N-40 must be filed.—Returns must be filed, on or before the 20th day of the 4th month following the close of the taxable year of the estate or trust, with the taxation district office in which the fiduciary resides or has its principal place of business. If the fiduciary has no residence or place of business in Hawaii, the return should be filed with the Department of Taxation, P.O. Box 3559, Honolulu, Hawaii 96811-3559. If the due date falls on a Saturday, Sunday, or holiday, the due date for the return is extended to the next business day.

C. Where to get forms.—If you need a Form N-40, you can get one from any taxation district office. The addresses of the taxation district offices

are as follows:

OAHU DISTRICT OFFICE, P.O. Box 3559, Honolulu, Hawaii 96811-3559.

MAUI DISTRICT OFFICE, P.O. Box 913, Wailuku, Hawaii 96793-0913.

HAWAII DISTRICT OFFICE, P.O. Box 1377, Hilo, Hawaii 96721-1377.

KAUAI DISTRICT OFFICE, P.O. Box 1688, Lihue, Hawaii 96766-5688.

To order tax forms by telephone, call (808) 587-7572, or toll free 1-800-222-7572.

D. Authentication.—Returns shall be authenticated by the signature of the individual fiduciary, or by the authorized officer of the organization receiving or having custody or control and management of the income of the estate or trust.

The Paid Preparer's Information at the bottom of page 1 of Form N-40 must be signed and completed by the person or in the name of the firm or corporation paid to prepare the fiduciary's return.

E. When and to whom the tax must be paid.—The tax of a trust or an estate must be paid in full when the return is filed.

The tax may be paid in cash or by check or money order made payable to the order of "Hawaii State Tax Collector."

Write your Federal Employer I.D. No. on the check or money order. Please draw your check on a U.S. bank and pay in U.S. dollars.

If the fiduciary expects a tax liability of \$500 or more, a declaration of estimated tax must be filed. See Form N-5 for more information.

F. Penalties and Interest.—For failure to file, pay or amend as required by law, penalties and interest will be added to the tax under section 235-104, HRS.

Late Filing of Return. The law provides a penalty of 5% of the tax due for each month, or part of a month, the return is late (maximum 25%) unless you can show reasonable cause for the delay. If you file a return late, attach a full explanation to your return.

Interest. Interest will be charged on taxes not paid by their due date, even if an extension of time to file is granted. The interest rate for not paying tax when due is $\frac{2}{3}$ of 1% of the unpaid amount for each month or part of a month it remains unpaid.

Failure to pay tax after filing timely returns. If a return is timely filed and the tax due is not completely paid within 60 days of the due date of the return, an amount up to 20% of the unpaid tax will be added to the tax due.

Underpayment of estimated taxes. The Department has been imposing the penalty for the underpayment of estimated tax as provided in section 235-97(f), HRS. If applicable, this penalty shall be added to the tax for the taxable year in an amount determined at the rate $\frac{2}{3}$ of 1% per month, or part of a month, upon the amount of the underpayment for the period of the underpayment.

Generally, if at least:

- (1) 90% (66 $\frac{2}{3}$ % for farmers and fishermen) of the

tax shown on the 1996 tax return;

- (2) 100% if the tax shown on the 1995 return (110% of that amount if the estate's or trust's adjusted gross income on that return is more than \$150,000, and less than $\frac{2}{3}$ of gross income for 1995 or 1996 is from farming or fishing); or
- (3) 90% of the tax figured by annualizing the taxable income and alternative minimum taxable income, whichever is smallest,

is not prepaid, a penalty for not paying enough estimated tax may be charged.

For more information regarding the underpayment penalty, see Form N-210.

G. Copy of governing instrument and fiduciary's declaration for estates and trusts created on or after January 1, 1958.—If the gross income of the estate or trust created on or after January 1, 1958, is \$5,000 or over, a copy of the will or trust instrument, sworn to by the fiduciary as a true and complete copy, must be filed with the return of the estate or trust, if not already filed.

The fiduciary shall attach to the return a statement expressing his or her opinion (indicating the relevant provisions of the governing instrument upon which he or she relies) as to the extent to which the income of the estate or trust is taxable to the estate or trust, to the beneficiaries, or to the grantor or a person other than the grantor. In making such determination, the fiduciary shall give particular attention to sections 671 through 676 and 678(a), (c), and (d) which relate (a) to taxation of the income of a trust to the grantor because of his or her retention or possession of (i) a reversionary interest, (ii) a power to revoke or to control beneficial enjoyment, (iii) administrative powers, or (iv) the right to income, and (b) to taxation of the income of a trust to a person other than the grantor because of the possession of such power over the trust as would constitute such a person the substantial owner of all or a portion of the trust.

If a copy of the governing instrument and a statement of the fiduciary have once been filed with a return, they need not again be filed, provided subsequent returns contain a statement showing when and where such documents were filed. However, if the instrument is amended in any way after a copy has been filed, a copy of the amendment must be filed with the return for the taxable year in which the amendment is made. A statement must also be filed by the fiduciary indicating the effect, if any, in his opinion, of such amendment on the extent to which the income of the trust is taxable to the trust, the beneficiaries, or to the grantor or a person other than the grantor.

H. Change in IRC taxable income, required reports.—

- (1) Section 235-101(b), HRS, requires a report to the Director of Taxation if the amount of IRC taxable income is changed, corrected, adjusted, or recomputed as stated in (3).
- (2) This report must be made:
 - (a) Within 90 days after a change, correction, adjustment or recomputation is finally deter-

mined.

- (b) Within 90 days after an amended return is filed.
 - (c) At the time of filing the next income tax return, if earlier than set forth in (a) or (b).
- (3) A report within the time set out in (2) is required if:
- (a) The amount of taxable income as returned to the United States is changed, corrected or adjusted by an officer of the United States other competent authority.
 - (b) A change in taxable income results from a renegotiation of a contract with the United States or a subcontract thereunder.
 - (c) A recomputation of the income tax imposed by the United States under the IRC results from any cause.
 - (d) An amended income tax return is made to the United States.
- (4) Effective January 1, 1994, the report referred to above shall be in the form of an amended Hawaii income tax return.
- (5) The statutory period for the assessment of any deficiency or the determination of any refund attributable to the report shall not expire before the expiration of one year from the date the Department is notified by the taxpayer or the Internal Revenue Service (IRS), whichever is earlier, of such a report in writing. Before the expiration of this one-year period, the Department of Taxation and the taxpayer may agree in writing to the extension of this period. The period so agreed upon may be further extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

I. Simple and complex trusts.—If the terms of the governing instrument of a trust require that all of its income (determined under the governing instrument and Hawaii law) be distributed currently and do not provide that any amounts may be paid, permanently set aside or used in the taxable year for the charitable purposes specified in section 642(c), such a trust may qualify as a “simple” trust under section 651(a). Such a trust is qualified under section 651(a) only in those taxable years of the trust in which it does not distribute to a beneficiary amounts other than amounts of income (determined under the governing instrument and local law) required to be distributed currently. Section 651(a) is not applicable to estates.

Any trust which does not qualify for the taxable year under section 651(a) is treated as a “complex” trust under section 661(a). All estates are treated under section 661(a) in the same manner as “complex” trusts.

J. Income in respect of a decedent.—Section 691 provides for the inclusion, when received, in gross income of an estate or trust of amounts of gross income which, although attributable to the decedent, were not properly includable in his or her return for any period up to the date of his or her death. This includes income from installment obligations. The same section allows deductions for business expenses, interest, taxes, etc., to the estate or other person receiving the property to

which the deduction pertains.

These provisions apply for state purposes if the decedent died on or after January 1, 1958. The taxable status of the income attributable to the decedent is the same as if the decedent had lived and received the income. Thus, if the decedent was a resident his or her income would be treated as though it had its source in Hawaii even if it had its source elsewhere, since the fact that the decedent was a resident in itself makes the income taxable. On the other hand, if the decedent's income had its source outside Hawaii and he or she was a nonresident, this income will be treated as wholly tax exempt.

Estate tax or Generation-Skipping Transfer (GST) tax previously paid to Hawaii, under Chapter 236D, HRS, which was attributable to the inclusion in a decedent's gross estate of the right to receive items of income treated as income in respect of a decedent and includable in gross income on the fiduciary return, is allowable as a deduction either to the fiduciary or to the beneficiaries, depending on whether or not such income is paid, credited, or required to be distributed. The fiduciary is entitled to deduct only the portion of the Chapter 236D, HRS, tax attributable to such income, which was not (during the taxable year in which received) paid, credited, or required to be distributed to a beneficiary. Any deductions in this connection to which beneficiaries are entitled should be shown in a statement attached to the return.

The credit on line 24(a) for taxes paid to other jurisdictions is limited to taxes imposed on the fiduciary itself as the taxpayer. Do not take any credit on line 24(a) for taxes imposed on the decedent even if paid by the fiduciary.

K. Income taxable to the grantor or substantial owner.—Report on Form N-40 the part of the income that is taxable to the trust. Do not report on Form N-40 the income that is taxable to the grantor or another person. Instead, attach a separate sheet to report the following:

- The income of the trust that is taxable to the grantor or another person under sections 671 through 678.
- The name, identifying number, and address of the person(s) to whom the income is taxable.
- Any deductions or credits applied to this income.

On page 1 at the top of Form N-40, write the name, identification number, and address of the grantor(s) or other person(s) in parentheses after the name of the trust.

The income taxable to the grantor or another person under sections 671 through 678 and the deductions and credits applied to the income must be reported on the income tax return that person files.

The grantor/trustee for a trust that was created in a tax year beginning on or after January 1, 1981, should not file Form N-40. The grantor/trustee must furnish his or her social security number to payers of income and report all items of income, deduction, and credit from the trust on his or her Form N-11 or Form N-12.

The grantor/trustee for a trust described above, including grantor trusts created in tax years beginning before 1981, who has previously filed Form

N-40 and who wants to take advantage of the simplified reporting requirements in the future should file a Form N-40 for the current year and write on it “pursuant to section 1.671-4(b), this is the final return for this grantor trust.” A grantor/trustee who chooses this option must furnish his or her social security number to payers of income for the next year and report the trust income on his or her Form N-11 or Form N-12 for the next year and for future years. The grantor/trustee must not file Form N-40 for future years.

L. At-risk loss limitations.—Generally, the amount the estate or trust has “at risk” limits the loss you can deduct for any tax year. Use federal Form 6198, At-Risk Limitations, to figure the deductible loss for the year and file it with Form N-40. For more information, see federal Form 6198, Publication 559, and Publication 925, Passive Activity and At-Risk Rules.

M. Passive activity loss limitations.—Section 469 generally limits deductions and credits derived from passive activities to the amount of income derived from all passive activities.

Generally, an activity is deemed to be passive if it involves the conduct of any trade or business, and the taxpayer does not materially participate in the activity. Passive activities do not include working interests in oil and gas properties (as defined in section 469(d)).

An estate or trust is treated as materially participating in an activity if an executor or fiduciary, in his or her capacity as such, is involved in operations of the activity on a regular, continuous, and substantial basis. In the case of a grantor trust, however, material participation is determined at the grantor level. Rental activities are considered to be passive activities, whether or not the taxpayer materially participates.

In the case of taxable years of an estate ending less than 2 years after the date of death of the decedent, up to \$25,000 of deductions and credit equivalents attributable to all rental real estate activities in which the decedent actively participated is allowed. Any unused losses and/or credits are deemed “suspended” passive activity losses for the year, and are carried forward indefinitely.

If the estate or trust distributes any interest in a passive activity, the basis of the property immediately before the distribution is increased by the passive activity losses allocable to the interest; and such losses are not allowable as a deduction. See section 469(j).

Note: *Losses from passive activities are first subject to the at-risk rules. When the losses are deductible under the at-risk rules, the passive activity rules then apply.*

Portfolio income is not treated as income from a passive activity, and passive losses and credits generally may not be applied to offset it. Portfolio income generally includes interest, dividends, royalties, and income from annuities. Portfolio income of an estate or trust must be accounted for separately, and may not be offset by losses from passive activities. See federal Form 8582, Passive Activity Loss Limitations, to compute the amount of allowable passive activity loss.

OF SPECIAL INTEREST TO BANKRUPTCY TRUSTEES AND DEBTORS-IN-POSSESSION

Taxation of Bankruptcy Estates of An Individual

Under section 1398(a), a bankruptcy estate is a

separate entity created when an individual debtor files a petition under either chapter 7 or 11 of title 11 of the United States Code. The estate is administered by a trustee, or a debtor-in-possession. If the

case is later dismissed by the bankruptcy court, the debtor is treated as if the bankruptcy petition had never been filed. This provision does NOT apply to partnerships and corporations.

Who Must File

Every trustee (or debtor-in-possession) for an individual's bankruptcy estate under chapter 7 or 11 of title 11 of the United States Code, must file a return if the bankruptcy estate has gross income for the tax year beginning in 1996 of \$1,990 or more.

Form N-40 is used ONLY as a transmittal for Form N-11, Hawaii Individual Income Tax Return (Resident), Form N-12, Hawaii Individual Income Tax Return (Resident or Part-Year Resident), or Form N-15, Hawaii Individual Income Tax Return (Non-Resident). Figure the tax for the bankruptcy estate on Form N-11, N-12, or N-15 using the following tax rate schedule.

If taxable income is:		The tax shall be:	
Over	But Not Over		Of the amount over
\$ 0	\$ 1,500	2.00%	\$ 0
1,500	2,500	\$30 plus 4.00%	1,500
2,500	3,500	70.00 plus 6.00%	2,500
3,500	5,500	130.00 plus 7.25%	3,500
5,500	10,500	275.00 plus 8.00%	5,500
10,500	15,500	675.00 plus 8.75%	10,500
15,500	20,500	1,112.50 plus 9.50%	15,500
20,500	—	1,587.50 plus 10.00%	20,500

Complete only the identification area at the top of Form N-40, enter any tax due from Form N-11, line 33; Form N-12, line 44; or Form N-15, line 43, to Form N-40, line 23. Sign and date the Form N-40.

Note: The filing of a tax return for the bankruptcy estate does not relieve the individual debtor of his or her (or their) individual tax obligations.

Federal Employer Identification No. (FEIN)

Every bankruptcy estate of an individual required to file a return must have its own FEIN. You may apply for one on federal Form SS-4, Application for Employer Identification Number. The social security number (SSN) of the individual debtor cannot be used as the FEIN for the bankruptcy estate.

Identification Area

Enter the name of the individual debtor on Form N-40 in the following format:
"John Q. Public Bankruptcy Estate".
Beneath, enter the name of the trustee in the following format:
"Mary Kealoha, trustee".

Date Entity Created

Enter the date the petition was filed; or the date of conversion to a chapter 7 or 11 case.

Period Covered By Return

A bankruptcy estate is allowed to have a fiscal year. The period can be no longer than 12 months; and the tax return must be filed on or before the 20th day of the 4th month following the close of the fiscal year.

Extension of Time To File

The trustee or debtor-in-possession for a bankruptcy estate should use Form N-100 to apply for an extension of time to file.

Disclosure of Return Information

Under section 235-116, HRS, tax returns of individual debtors who have filed for bankruptcy under chapter 7 or 11 of title 11 are, upon written request, open to inspection by or disclosure to the trustee.

The returns subject to disclosure to the trustee are those for the year the bankruptcy begins and prior years. Use Form L-72, Request for Copies of Income Tax Returns (available at any District Office), to request copies of the individual debtor's tax returns.

If the bankruptcy case was not voluntary, disclosure cannot be made before the bankruptcy court has entered an order for relief, unless the court rules that the disclosure is needed for determining whether relief should be ordered.

Transfer of Tax Attributes From the Individual Debtor to the Bankruptcy Estate

Under section 1398(g), the bankruptcy estate succeeds to the following tax attributes of the individual debtor:

- Net operating loss carryovers;
- Charitable contributions carryovers;
- Recovery of tax benefit items;
- Credit carryovers;
- Capital loss carryovers;
- Basis, holding period, and character of assets;
- Method of accounting; and

- Other tax attributes that may be prescribed by the Department of Taxation.

Income and Deductions

Under section 1398(c), the taxable income of the bankruptcy estate is computed in the same manner as an individual. The gross income of the bankruptcy estate includes any income as defined in Bankruptcy Code section 541. Also included is gain from the sale of property. To compute gain, the trustee or debtor-in-possession must determine the correct basis of the property.

Amounts paid or incurred by the bankruptcy estate are allowable as deductions or credits; or treated as wages, as if the individual debtor were still engaged in the trades and businesses, or activities, that the individual debtor was engaged in before the bankruptcy proceedings began.

Exemption.—A bankruptcy estate is allowed a personal exemption of \$1,040.

Standard deduction.—A bankruptcy estate that does not itemize deductions is allowed a standard deduction of \$950.

Net operating loss (NOL).—The bankruptcy estate may have a NOL for the tax year if the estate's administrative expenses exceed the estate's gross income. The NOL created may be carried back to each of the 3 preceding tax years, and carried forward to each of the 7 succeeding years.

Discharge of indebtedness.—In a title 11 case, gross income does not include amounts that normally would be included in gross income resulting from the discharge of indebtedness. However, any amount excluded from gross income must be applied to reduce certain tax attributes in a certain order.

Use federal Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, to show the reduction of tax attributes. However, for Hawaii purposes the following reductions are not operative and are not allowed as exclusions:

- General business credit;
- Minimum tax credit; and
- Foreign tax credit carryovers.

The specific instructions that follow this section explain how all trusts and estates should fill in the

form. However, since the schedules on page 2 of the return are necessary only for complex trusts, the

instructions relating to the schedules on that page may be disregarded by simple trusts.

HOW TO FILL IN FORM N-40

SIMPLE TRUSTS MAY USE THE FOLLOWING-DESCRIBED SHORT-FORM METHOD OF COMPLETING THEIR RETURNS

Simple trust without capital gains (or losses).

(a) **Reporting Income and deductions.** Fill in page 1, lines 1 through 18 in accordance with specific instructions.

(b) **Determine taxable income and tax**

of fiduciary. If the amount shown on line 17 is not more than the amount of income required to be distributed currently, enter on line 18 the amount shown on line 17 and enter zero on line 22. Lines 23 through 31 need not be completed.

If the amount shown on line 17 exceeds the

amount of income required to be distributed currently less nontaxable income, enter on line 18 the amount of income required to be distributed currently and complete the remainder of page 1.

A—SPECIFIC INSTRUCTIONS FOR RESIDENT ESTATES AND TRUSTS

Any intangible income, such as dividends and interest, shall be excluded from the gross income

earned by a resident trust to the extent that, during the trust's taxable year, the beneficial interest in the

trust is held by a non-resident beneficiary(ies). This exclusion does not apply, however, to income re-

ceived from real property held in a land trust formed under Chapter 558, HRS.

Line 1. Interest income.—Enter the fiduciary's share of all taxable interest income including any original issue discount, and income received as a regular interest holder of a Real Estate Mortgage Investment Conduit (REMIC). For taxable bonds acquired after December 31, 1987, amortizable bond premium is treated as an offset to the interest income instead of as a separate interest deduction. See Publication 550.

Line 2. Dividends.—Enter the fiduciary's share of all taxable dividends received by the estate or trust.

Line 3. Income or (losses) from partnerships, other estates or other trusts.—Enter on line 3 all income or (losses) from partnerships except the following:

- Interest (enter on line 1)
- Dividends (enter on line 2)
- Capital gain or (loss) (enter on Schedule D Form N-40).
- Ordinary gain or (loss) (enter on Schedule D-1).

Also write the partnership name and address on line 3. If there is more than one partnership, list the names and addresses on an attached sheet. Attach a copy of federal Schedule E, Supplemental Income Schedule, to the return.

Line 4. Rent and royalty income or (loss). Enter the net rent and royalty income or loss on line 4. Attach federal Schedule E, Supplemental Income Schedule, to show the fiduciary's share of income and expenses including depreciation and depletion. This will be the same as the amount shown on federal Form 1041.

For a trust, divide the deductions for amortization, depreciation, and depletion between the fiduciary and the beneficiaries as specified in the trust instrument. If the trust instrument does not so specify, divide the deductions on the same basis as the trust instrument provides for dividing the income between the fiduciary and the beneficiaries. For an estate, divide the deductions for amortization, depreciation, and depletion between the estate and the beneficiaries in the same way the estate income is allocated to each. See federal Regulations sections 1.642(e)-1, 1.642(f)-1, 1.167(f)-1, 1.167(h)-1, and 1.611-1(c) for more information about the division of these deductions. If the estate or trust has a loss from an activity, see "At-Risk Loss Limitations" and "Passive Activity Loss Limitations" discussed above.

Attach federal Form 4562, Depreciation and Amortization, to explain any depreciation, and amortization deduction. Attach a separate computation for any depletion deduction.

Note: *An estate or trust cannot make an election under section 179 to expense certain depreciable business assets.*

Line 5. Net business and farm income or (loss).—Enter the net profit or loss from business and farming during the tax year. Attach federal Schedule C, Profit or Loss from Business or Profession, to report the business income or loss. Attach federal Schedule F, Farm Income and Expenses, to report the farm income or loss. Complete all information on federal Schedules C and F that applies to the estate or trust. Remember to write the estate's or trust's general excise tax license number on the schedules.

See the instructions for lines 4 and 15(a) for more information on dividing the deductions for amortization, depreciation, and depletion between the fiduciary and the beneficiaries.

Line 6. Capital gain or (loss).—Enter from Schedule D (Form N-40) the gain or loss from the sale or exchange of capital assets.

Line 7. Ordinary gain or (loss).—Enter from Schedule D-1 the gain or loss from the sale or exchange of property other than capital assets and also from involuntary conversions (other than casualty or theft). For more information, see the instructions for Schedule D-1.

Line 8. Other Income.—Enter the total taxable income not reportable elsewhere. State the nature of the income. Attach a separate sheet if necessary.

Examples of income to be reported on line 8 are:

- Wages and salaries received by the decedent's estate that are income in respect of a decedent. See Publication 559 for more information.
 - The estate's or trust's share of aggregate income or loss that is ordinary income if the estate or trust is a shareholder of an S corporation. Also state the name and FEIN of the corporation. Report capital gain income, dividend income, etc., on other appropriate lines.
 - The estate's or trust's share of taxable income or (loss) if the estate or trust is a residual holder of a REMIC. You should receive federal Schedule Q (Form 1066) and instructions from the REMIC for each quarter.
- See the federal instruction for Schedule E for reporting requirements, and attach federal Schedule E.
- Any part of a total distribution shown on federal Form 1099-R, Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, etc., that is treated as ordinary income.

For more information, see the separate instructions for Form N-152, Tax on Lump-Sum Distributions.

For more information, see Miscellaneous Taxable Income, in Publication 525, Taxable and Nontaxable Income.

Deductions

Allocation of deductions for tax-exempt income.—All deductions entered on lines 10 through 15(b) must include only the fiduciary's share of deductions related to taxable income. If the estate or trust has tax-exempt income, the amount included on lines 10 through 15(b) must be reduced by the allocable portion attributed to tax-exempt income. The allocable amounts to be included on lines 10 through 15(b) are determined as follows:

1. **Determine the percentage of tax-exempt income to gross income.**—Divide the total tax-exempt income received by the total of all items of gross income (including tax-exempt income) included in distributable net income.
2. **Determine the excludable amount of each specific deduction.**—Multiply the percentage of tax-exempt income by each specific deduction.
3. **Determine the amount deductible on lines 10 through 15(b).**—Subtract the excludable amount of each specific deduction from the specific deduction and enter the balance on the appropriate line.

For more information, see Publications 550 and 559.

Deductions that may be allowable for estate tax purposes.—Administration expenses and losses deductible on federal Form 706 may be

deducted instead on Form N-40 if the fiduciary files a statement waiving the right to deduct the expenses and losses on federal Form 706. The statement must be filed before the expiration of the statutory period of limitations applicable to the tax year for which the deduction is claimed. *You cannot deduct on Form N-40 a decedent's medical and dental expenses that are paid by the fiduciary.* See Publication 559 for more information.

Accrued expenses.—Generally, an accrual basis taxpayer can deduct accrued expenses in the tax year that: (1) all events have occurred that determine the liability; and (2) the amount of the liability can be figured with reasonable accuracy. However, all the events that establish liability are treated as occurring only when economic performance takes place. There are exceptions for recurring items. See section 461(h).

Line 10. Interest.—Enter any deductible interest paid or accrued that is not deductible elsewhere on Form N-40. Do not include interest on a debt that was incurred or continued in order to buy or carry obligations that yield tax-exempt interest. If unpaid interest is due related persons, see Publication 545, Interest Expense.

Fully deductible interest includes:

- (1) interest paid or accrued on indebtedness incurred in connection with the conduct of a trade or business;
- (2) any investment interest (subject to limitations);
- (3) any "qualified residence interest"; or
- (4) any interest payable under section 6601 on any unpaid portion of the estate tax attributable to the value of a reversionary or remainder interest in property, or an interest in a closely held business for the period during which an extension of time for payment of such tax is in effect.

Interest paid or accrued by an estate or trust on indebtedness secured by a qualified residence of a beneficiary of an estate or trust is treated as "qualified residence interest" if the residence would be a qualified residence (i.e., the principal residence or the second residence selected by the beneficiary) if owned by the beneficiary. The beneficiary must have a present interest in the estate or trust or an interest in the residuary of the estate or trust. See Publication 936, Limits on Home Mortgage Interest Deduction, for an explanation of the general rules for deducting home mortgage interest.

See section 163(h)(3) for a definition of "qualified residence interest" and limitations on indebtedness.

Generally, "investment interest" is interest (including amortizable bond premium on taxable bonds acquired after 10/22/86, but before 1/1/88) that is paid or accrued on indebtedness that is properly allocable to property held for investment. Investment interest does not include any "qualified residence interest," or interest that is taken into account under section 469 in computing income or loss from a passive activity.

Generally, net investment income is the excess of investment income over investment expenses. Investment expenses are those expenses (other than interest) allowable after application of the 2% floor on miscellaneous itemized deductions.

The amount of investment interest deduction may be limited. Use Form N-158, Investment Interest Expense Deduction, to compute the allowable investment interest deduction.

Any disallowed investment interest expense is allowed as a carryforward to the next tax year. See section 163(d) and Publication 550, for more information.

If the allowable part of the excess investment

interest expense is deductible, write "Form N-158 attached" on line 10. Then add the deductible interest figured on Form N-158 to the other types of deductible interest and enter the total on line 10.

Personal interest is not deductible. This includes interest paid on:

- Revolving charge accounts.
- Personal notes for money borrowed from a bank, credit union, or another person.
- Installment loans on personal property.
- Taxes.

Line 11. Taxes.—Enter any deductible taxes paid or accrued during the tax year that are not deductible elsewhere on Form N-40. State and local sales taxes are not deductible. Instead, they are to be treated as part of the cost of the property upon acquisition, or as a reduction in the amount realized upon disposition.

Deductible taxes include:

- State and local income or real property tax.
- The GST imposed on income distributions.

Nondeductible taxes include:

- Federal income and excise taxes.
- Customs duties.
- State and local sales taxes.
- Federal and State estate taxes, but see line 19 and General Instruction J.

Line 12. Fiduciary fees.—Enter the total deductible fees paid to the fiduciary for administering the estate or trust during the tax year.

Fiduciary fees deducted on federal Form 706, Estate Tax Return, cannot be deducted on Form N-40.

Line 13. Charitable deduction.—Enter the total from Schedule A (Form N-40) line 6 or 7(c).

Line 14. Attorney, accountant, and return preparer fees.—Enter the deductible attorney, accountant, and return preparer fees paid for the estate or trust during the tax year.

Line 15(a). Other deductions NOT subject to the 2% floor.—Use Schedule C (Form N-40) to list all authorized deductions that are not deductible elsewhere on Form N-40.

Include on Schedule D (Form N-40) as losses on capital assets, any losses on worthless bonds and similar obligations and nonbusiness bad debts.

See Publication 550 for more information on expenses of producing income.

Bond premium(s).—The rules for amortizing bond premiums are different for taxable bonds and tax-exempt bonds.

For taxable bonds acquired before 10/23/86:

- You may elect to amortize the premium.
- Only the fiduciary may make the election for the estate or trust.
- The basis must be reduced if you elect to amortize.

For tax-exempt bonds:

- You must amortize the premium.
- You may not deduct the amortization of premium from income.
- The basis must be reduced by the amortization of the premium.

For more information, see section 171 and Publication 550.

If you claim a bond premium deduction for the

estate or trust, figure the deduction on a separate sheet and attach it to this return.

Casualty and theft losses.—Use federal Form 4684, Casualties and Thefts, to report casualty and theft losses.

If you have any sales, exchanges, or involuntary conversions (other than casualty or theft) of property used in a trade or business, or any involuntary conversions (other than casualty or theft) of certain capital assets, use Schedule D-1.

Deduction for clean-fuel vehicles.—Section 179A allows a deduction for part of the cost of qualified clean-fuel vehicle property. See Publication 535, Business Expenses for more details.

NOL deduction.—An estate or trust is allowed the NOL deduction under section 172. In computing the NOL, exclude that portion of the income and deductions attributable to the grantor under sections 671 through 678. Also, the charitable contribution deduction under section 235-2.4(h)(2), HRS, and the income distribution deductions under sections 651 and 661 are not allowed.

The estate or trust is allowed the carryback and carryforward period for the NOL deduction.

For more information, see Publication 536, Net Operating Losses, and Form N-109, Application for Tentative Refund. If you claim a NOL deduction for the estate or trust, figure the deduction on a separate sheet and attach it to this return.

Fiduciary's share of amortization, depreciation, and depletion not claimed elsewhere.—If you cannot deduct the amortization, depreciation, and depletion as rent or royalty expenses on federal Schedule E, or as business or farm expenses on federal Schedules C and F, itemize the fiduciary's share of the deductions on Schedule C. Then include them on line 15(a). Itemize each beneficiary's share of the deductions on the appropriate line of Schedule K-1 (Form N-40). See the instructions for Schedule K-1 for more information, including the rules for dividing the deductions between the fiduciary and the beneficiaries.

Restricted deductions.—For the special rules on real property construction period interest and taxes for trade or business and activities conducted for profit, see Publication 535, Business Expenses.

For information on unpaid expenses due related persons, see Publication 550.

For the rules on the tax year for which a deduction is claimed, including the limit for expenses paid in advance, see Publication 538.

For the limit on deductions for certain farming syndicates, see Publication 535.

Line 15(b). Allowable miscellaneous itemized deductions subject to the 2% floor.—Miscellaneous itemized deductions are deductible only to the extent that the aggregate amount of such deductions exceeds 2% of adjusted gross income (AGI).

The term "miscellaneous itemized deductions" does not include deductions relating to:

- Interest under section 163.
- Taxes under section 164.
- The amortization of bond premium under section 171.
- Estate taxes in the case of income in respect of a decedent under section 691(c).

For more exceptions, see section 67(b).

For estates and trusts, the AGI is computed by subtracting the following from total income (line 9):

- (1) the administration costs of the estate or trust (the total of lines 12, 14, and 15 to the extent they are costs incurred in the administration of

the estate or trust) that would have not been incurred if the property were NOT held by the estate or trust;

- (2) the income distribution deduction under section 651 or 661 (line 18);
- (3) the amount of the exemption (line 20); and
- (4) other deductions claimed on lines 10 through 15(a) that were incurred in the conduct of a trade or business, or the production of income.

Allowable administration costs are those costs incurred with the administration of the estate or trust which would not have been incurred if the property were not held in such estate or trust. These administration costs are not subject to the 2% floor.

For those estates and trusts whose income distribution deduction is limited to the actual distribution, and NOT the distributable net income (DNI), (i.e., the net income distribution is less than the DNI) when computing the AGI, use the amount of the actual distribution.

For those estates and trusts whose income distribution deduction is limited to the DNI (i.e., the actual distribution exceeds the DNI), the DNI must be computed taking into account the allowable miscellaneous itemized deductions (AMID) after application of the 2% floor. In this situation there are two unknown amounts: the AMID; and the DNI.

The following example illustrates how an algebraic equation can be used to solve for these unknown amounts:

The Malcolm Smith Trust, a complex trust, earned \$20,000 of dividend income, \$20,000 of capital gains, and a fully deductible \$5,000 loss from XYZ partnership (chargeable to corpus) in 1996. The trust instrument provides that capital gains be added to corpus. 50% of the fiduciary fees were allocated to income and 50% to corpus. The trust claimed a \$2,000 deduction on line 12 of Form N-40. The trust incurred \$1,500 of miscellaneous itemized deductions (chargeable to income), which are subject to the 2% floor. There are no other deductions. The trustee made a discretionary distribution of the accounting income of \$17,500 to the trust's sole beneficiary.

Since the actual distribution can reasonably be expected to exceed the DNI, the trust must compute the DNI, taking into account the allowable miscellaneous itemized deductions, to determine the amount to be entered on line 15(b).

The trust also claims an exemption of \$80 on line 20.

To compute line 15(b), solve the equation below:

$$\text{AMID} = \text{total miscellaneous itemized deductions} - (.02(\text{AGI}))$$

In the above example:

$$\text{AMID} = 1,500 - (.02(\text{AGI}))$$

In all situations, use the following equation to compute the AGI:

$$\text{AGI} = (\text{line 9}) - (\text{the total of lines 12, 14, and 15(a) to the extent they are costs incurred in the administration of the estate or trust that would have not been incurred if the property were NOT held by the estate or trust}) - (\text{line 18}) - (\text{line 20})$$

In the above example:

$$\text{AGI} = 35,000 - 2,000 - \text{DNI} - 80$$

Since the value of line 18 is not known because it is limited to the DNI, you are left with the following:

$$\text{AGI} = 32,920 - \text{DNI}$$

Substitute the value of AGI in the equation:

$$\text{AMID} = 1,500 - (.02(32,920 - \text{DNI}))$$

The equation cannot be solved until the value of DNI is known. The DNI can be expressed in terms of the AMID. To do this, compute the DNI using the known values. In this example, the DNI is equal to the total income of the trust (less any capital gains allocated to corpus; or plus any loss from line 4); less total deductions from line 16 (computed without regard to any miscellaneous itemized deductions); less the AMID.

Thus, $DNI = (\text{line 9}) - (\text{line 17 column (b) of Schedule D (Form N-40)}) - (\text{line 16}) - (\text{AMID})$

Substitute the known values:

$$DNI = 35,000 - 20,000 - 2,000 - \text{AMID}$$

$$DNI = 13,000 - \text{AMID}$$

Substitute the value of DNI into the equation to solve for AMID:

$$\text{AMID} = 1,500 - (.20(32,920 - (13,000 - \text{AMID})))$$

$$\text{AMID} = 1,500 - (.02(32,920 - 13,000 + \text{AMID}))$$

$$\text{AMID} = 1,500 - (658 - 260 + .02 \text{ AMID})$$

$$\text{AMID} = 1,102 - .02 \text{ AMID}$$

$$\text{AMID} = 1,080$$

$$DNI = 11,920$$

$$AGI = 21,000 \text{ (i.e., } 32,920 - 11,920)$$

Note: The income distribution deduction is equal to the lesser of the distribution (\$17,500) or the DNI (\$11,920).

Enter the value of AMID on line 15(b) (the DNI should equal line 9 of Schedule B) and complete the rest of Form N-40 according to the instructions.

Line 17. Adjusted total income or (loss).—If you are filing for a year other than the final year, and line 16 is more than line 9, you may have a NOL. Use Form N-109, Application for Tentative Refund, to determine whether you have an NOL that you can carry back or forward.

If you are filing for the final year, and the amount on line 16 is more than the amount on line 9, then you have excess deductions. Excess deductions can only be distributed to a beneficiary on the final return of the estate or trust. For more information, see the instructions for Schedule K-1, line 9.

Line 18. Income distribution deduction.—If this trust is other than a "Simple Trust" or "Pooled Income Fund," complete Schedule B on page 2. However, if line 17 is equal to or less than zero and no distributions were actually made or available on demand to the beneficiaries in the tax year, then do not complete Schedule B.

Cemetery perpetual care fund.—On line 18, deduct the amount, not more than \$5 per gravesite, paid for maintenance of cemetery property. Write the number of gravesites to the right of the entry space for line 18. Also write "Section 642(i) trust" in parentheses after the trust's name at the top of Form N-40. You do not have to complete Schedule B of (Form N-40) and Schedule K-1 (Form N-40).

Line 19. Hawaii estate and GST tax attributable to income in respect of a decedent (fiduciary's share).—See General Instruction J.

A deduction is allowed for the GST tax imposed as a result of a taxable termination, or a direct skip occurring as a result of the death of the transferor. See Publication 448 and section 691(c)(3). Enter the fiduciary's share of these deductions on line 19.

Line 20. Deduction for personal exemption.—An estate is allowed a deduction of \$400. A trust which, under its governing instrument, is required to distribute all of its income currently, is allowed a deduction of \$200; all other trusts are allowed a deduction of \$80.

Note: No exemption is allowed on the final return

of an estate or trust.

Line 23. Tax.—If the Alternative Tax Computation on Schedule D (Form N-40) is not used, the amount of the tax shall be determined in accordance with the following rate schedule:

If the taxable income (line 22) is:		The tax shall be:	
Over	But Not Over		Of the amount over
\$ 0	\$ 1,500	2.00%	\$ 0
1,500	2,500	\$30 plus 4.00%	1,500
2,500	3,500	70.00 plus 6.00%	2,500
3,500	5,500	130.00 plus 7.25%	3,500
5,500	10,500	275.00 plus 8.00%	5,500
10,500	15,500	675.00 plus 8.75%	10,500
15,500	20,500	1,112.50 plus 9.50%	15,500
20,500	—	1,587.50 plus 10.00%	20,500

Section 644 tax on trusts.

If the trust sells or exchanges property at a gain within 2 years after receiving it from a transferor, a section 644 tax may be due. The tax may be due if both (i) and (ii) below apply:

- There is an includable gain recognized by the trust; and
- At the time the trust received the property, the property had a fair market value higher than its adjusted basis.

For federal purposes the trustee is authorized by section 6103(e)(1)(A)(ii) to inspect the transferor's income tax return to the extent necessary to figure the section 644 tax if the transferor refuses to make a disclosure to the trustee.

Includable gain is the smaller of (i) or (ii) below:

- The gain recognized by the trust on the sale or exchange of the property; or
- The amount by which the fair market of the property at the time of the initial transfer to the trust exceeds the adjusted basis of the property immediately after the transfer.

Figure the tax on the gain by subtracting the transferor's actual tax for the tax year of the sale or exchange from the transferor's tax for the year of the sale or exchange refigured to include the recognized gain minus any deductions allocable to the gain.

See section 644 for additional information, including character rules, special rules, exceptions, installment sale rules, and the interest on the tax if the transferor and the trust have different tax years.

Include the section 644 tax on line 23. Attach the section 644 tax computation to the return. Do not include the section 644 gain in the trust's taxable income.

Line 24. Total non-refundable credits from Schedule E, line 6.—Enter on this line the total non-refundable credits being claimed by the estate or trust from Schedule E, line 6.

Line 26(a). Credit for estimated tax payments.—Enter on this line the total estimated taxes paid by the estate or trust for 1996. Show the breakdown of the total paid on Forms N-5 and N-288A (net of N-288C refunds) in the appropriate spaces.

Line 26(b). Estimated tax payments allocated to beneficiaries.—A trust or a decedent's estate may elect to have any part of its estimated tax payments treated as made by a beneficiary or beneficiaries. The fiduciary fills out Schedule T to make the election. Enter the amount from Schedule T, line 1, here.

Line 26(d). 1995 overpayment applied to 1996 estimated tax.—Enter on this line any overpayment from the 1995 return that was applied to the 1996 estimated tax.

Line 26(e). Credit for taxes paid on extension.—Attach Form N-100.

Line 26(f). A Capital Goods Excise Tax Credit is available for tangible personal property purchased and used in a trade or business in Hawaii.—The amount of the tax credit allowable is 4% of the cost of the qualified tangible property acquired in 1996. The tax credit is applied against a taxpayer's net income tax liability, the excess will be refunded to the taxpayer. See Form N-312 for additional information.

Line 26(g). Other credits.—Include on this line the total of amounts claimed for the credits described below:

Credit for tax deemed paid on undistributed capital gains of regulated investment companies.—In the case of a shareholder of a regulated investment company there is allowed a credit in the amount of 4% of the amount of capital gains which, by section 852(b)(3)(D), is required to be included in the shareholder's return and on which there has been paid to Hawaii by the regulated investment company the tax of 4%, imposed by subsection (b) of section 235-71, HRS.

Fuel tax credit for commercial fishers.—Each principal operator of a commercial fishing vessel may claim a credit against his or her Hawaii State individual net income tax. The tax credit shall be an amount equal to the fuel taxes imposed under section 243-3(a), HRS, and paid by the principal operator during the year. In this respect, a fiduciary is required to prepare an Information Statement, Form N-163A, for each individual beneficiary in order that the prorated amount of the fiduciary's tax credit may be claimed by the individual taxpayer on Form N-163.

Line 28. Penalty for underpayment of estimated tax.—See General Instruction F and Form N-210.

Schedule A — Page 2 Treatment of charitable contributions; computation of charitable deduction.

Subject to certain limitations, an estate or trust shall be allowed a deduction for any amount of gross income which pursuant to the terms of the governing instruments is, during the taxable year, paid or permanently set aside for a purpose specified in section 170(c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit. This deduction is not subject to any percentage limitation if the charitable contributions are to be used exclusively in Hawaii (unless the limitations of section 681 apply). Under Chapter 235, HRS, the deduction is the sum of (a) the amount to be used exclusively in Hawaii and (b) the excess of the total contributions over the amount of contributions used exclusively in Hawaii. The amount determined in (b) is subject to the same limitations applicable to contributions made by individuals. These limitations are computed as follows: (1) the amount actually paid within the taxable years to a church, educational organization, or hospital, qualified under section 170(b)(1)(A) but not in excess of 50% of taxable

income (page 1, line 22, computed without any charitable contributions deduction on line 13 or the exemption on line 20), plus (2) any other amount actually paid other than a charitable contribution to which section 170(b)(1)(A) applies shall be allowed as a deduction to the extent that the aggregate of such contribution does not exceed the lesser of: (a) 20% of the taxable income (page 1, line 22, computed without any charitable contribution on line 13 or exemption on line 20), or (b) the excess of 50% of the taxable income (page 1, line 22, computed without any charitable contribution or exemption on line 20) for the taxable year over the amount of charitable contributions qualifying for the 50% deduction ceiling.

"Charitable contributions" means any amount of gross income which is paid, permanently set aside, or used in such manner as to qualify for the charitable contributions deduction (except for the special limitation in Chapter 235, HRS) is referred to in these instructions as a "charitable contribution."

Line-by-Line Instructions

Line 1.—Enter on this line the full amount paid or permanently set aside for the purposes described above out of the current year's income. This does not include capital gains allocable to corpus, but does include capital gains which are treated as income under the governing instrument and Hawaii law. Capital gains reported on Schedule D (Form N-40), which are allocable to corpus, should be entered on line 4.

Line 2.—This line provides for an adjustment of the charitable contributions attributable to income of the current year (line 1), so that the charitable deduction will not include contributions attributable to tax-exempt interest or other nontaxable income. In the absence of specific provisions in the governing instrument, enter on line 2(a) the result obtained by multiplying line 1 by the total of all tax-exempt interest and other income which is nontaxable irrespective of source, included in income of the current year (under the governing instrument and Hawaii law), and dividing by the total of all the income items included in income of the current year (under the governing instrument and Hawaii law). In computing the total of all items of income under applicable local law, do not reduce income by any losses (such as losses from the sale or exchange of property). In the case of a nonresident estate or trust, enter on line 2(b) the result obtained by multiplying line 1 by the total of all income which is nontaxable because it is derived from property owned outside Hawaii or from other sources outside of Hawaii but which is included in income of the current year, under the governing instrument or Hawaii law, and dividing by the total of all the income items included in income of the current year determined as above stated. The nonresident estate or trust should include, as income which is nontaxable because of source outside Hawaii, the capital gains from property owned outside Hawaii if the capital gains are allocable to income.

Line 4.—Enter the total of all net short-term capital gain and net long-term capital gain of the current year that is:

- Allocable to corpus or
- Paid or permanently set aside for charitable purposes; and
- Not included on line 1.

Line 5.—Enter the total of deductible amounts paid or permanently set aside for charitable purposes from gross income of a prior tax year (and for which no charitable deduction was claimed in the prior tax year). Attach a statement to show the details.

Schedule B — Page 2

Income distribution deduction.

General Instructions

The term "distributable net income" (DNI) limits the deductions allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries and is used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includable in his or her gross income.

Separate share rule.—If a single trust has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the DNI allocable to the respective beneficiaries. If the separate share rule applies, figure the DNI allocable to each beneficiary on a separate sheet and attach the sheet to this return. For more information, see section 663(c) and related regulations.

Line-by-Line Instructions

Line 1.—Enter the amount shown on page 1, line 17, computed by using Schedule A, line 6, for page 1, line 13. If the amount is a loss, enter zero on line 1, Schedule B, unless the loss is attributable to the capital loss limitation rules under section 1211(b). If the loss is attributable to the section 1211(b) rules, enter on line 1, Schedule B, the smaller of the net loss from line 17 of page 1, Form N-40, or the loss from line 6 of page 1, Form N-40.

Line 2(a).—Enter the amount of tax-exempt interest and other nontaxable income received, less: (i) the amount of tax-exempt income shown on Schedule A line 2(a); and (ii) any amounts which, but for the provisions of section 265, would be deductible in respect of disbursements, expenses, losses, etc., of the trust or estate, directly or indirectly allocable to such income. The amount of the indirect disbursements, etc., allocable to a tax-exempt income is that amount which bears the same ratio to the total disbursements, etc., of the trust or estate not directly attributable to other items of income as the total tax-exempt income received bears to the total of all the items of gross income (including tax-exempt income and, in the case of a nonresident estate or trust, income which is nontaxable because it is derived from property owned outside Hawaii or from other sources outside Hawaii) entering into distributable net income.

Line 2(b).—In the case of a nonresident estate or trust, enter the amount of income which is nontaxable because it is derived from property owned outside Hawaii or from other sources outside Hawaii, adjusted in the same manner as the tax-exempt income. Include capital gains which are paid, credited, or required to be distributed to beneficiaries but are not taxable to the nonresident estate or trust because it is derived from property owned outside Hawaii.

Line 5. Long-term capital gains distributed for charitable purposes.—Figure the amount to enter on line 5 as follows: Multiply line 1 of Schedule A by a fraction; the numerator of which is the amount of long-term capital gains that are included in the accounting income of the estate or trust (i.e., not allocated to corpus) AND are distributed to charities; the denominator of which is all items of income (including the amount of such long-term capital gains) included in DNI.

Line 6. Short-term capital gains distributed for charitable purposes.—Figure line 6 in the same manner as line 5, except the numera-

tor of the fraction includes only short-term capital gains that are included in the accounting income of the estate or trust and distributed to charities.

Line 10.—If you are filing for an estate, enter -0-. If you are filing for a simple or a complex trust, enter the income for the tax year determined under the terms of the governing instrument and applicable Hawaii law. Do not include extraordinary dividends or taxable stock dividends determined under the governing instrument and applicable Hawaii law to be attributable to corpus.

Lines 11 and 12

Do not include any:

- Amounts deducted on an earlier year's return that were required to be distributed in the earlier year.
- Amount that is properly paid or credited as a gift or bequest of a specific amount of money or specific property. (To qualify as a gift or bequest, the amount must be paid in three or fewer installments.) An amount that can be paid or credited only from income is not considered a gift or bequest.
- Amount paid or permanently set aside for charitable purposes or otherwise qualifying for the charitable deduction.

Line 11.—Enter income of the estate or trust that is required to be distributed currently to all beneficiaries, whether it is distributed or not. The governing instrument and Hawaii law determine the items of income and whether an amount must be distributed currently. If the governing instrument requires that stated amounts be paid to a beneficiary and that these amounts may come from either income or corpus, include on line 11 any part these amounts paid from the current year's income.

Line 12.—Enter other amounts actually paid, credited or required to be distributed to beneficiaries in the tax year, whether from income or corpus.

Unless a section 643(e)(3) election is made, the value of all noncash property actually paid, credited, or required to be distributed to any beneficiaries after June 1, 1984, is the smaller of:

- (1) The estate's or trust's adjusted basis in the property immediately before distribution, plus any gain or minus any loss recognized to the estate or trust on the distribution (basis of beneficiary), or
- (2) The fair market value of such property. This rule does not apply to any noncash property distributed in satisfaction of a specific sum of money. If a section 643(e)(3) election is made by the fiduciary, then the amount entered on line 12 will be the fair market value of the property.

Line 13. Total distributions.—Add lines 11 and 12 and enter the total on line 13. If line 13 is more than line 10 and you are filing for a complex trust, complete Schedule J (Form N-40) and file it with Form N-40 unless the complex trust has no previously accumulated income.

Line 14.—In computing the income distribution deduction for beneficiaries, the estate or trust is not allowed a deduction for any item of DNI that is not included in the gross income of the estate or trust. Thus, for purposes of computing the allowable income distribution deduction, the DNI (line 9) is computed without regard to any tax-exempt interest.

If tax-exempt interest is the only tax-exempt income included in the total distributions (line 13), and the DNI (line 9) is less than or equal to line 13, then enter on line 14 the amount from line 2(a).

If tax-exempt interest is the only tax-exempt

income included in the total distributions (line 13), and the DNI is more than line 13 (i.e., the estate or trust made a distribution that is less than the DNI), then compute the adjustment as follows:

Multiply line 2(a) by a fraction; the numerator of which is the total distributions (line 13), and the denominator of which is the DNI (line 9). Enter the result on line 14.

If line 13 includes tax-exempt income other than tax-exempt interest, figure line 14 as follows:

From tax-exempt income included on line 13, subtract the total of:

- (1) the charitable contribution deduction allocable to such tax-exempt income, and
- (2) expenses allocable to tax-exempt income. To compute the expenses allocable to tax-exempt income, divide tax-exempt income by total income. Multiply the result by expenses not directly allocable to any item of income.

MULTISTATE TAX COMPACT ACT.—Any taxpayer, other than a corporation, acting as a business entity in more than one state who is required by the Hawaii Income Tax Law to file a return and whose only activities in this State consist of sales and who does not own or rent real estate or tangible personal property and whose annual gross sales in or into the State during the tax year is not in excess of \$100,000 may elect to report and pay a tax of .5% of such annual gross sales. Taxpayers who elect the foregoing shall file Form N-310.

Schedule C — Page 3 Explanation of deductions.

Itemize in Schedule C the deductions for interest and taxes, and other deductions claimed on page 1, lines 10, 11, 12, 14, 15(a), and 15(b). If the space provided on the form is insufficient, attach a separate schedule.

Instructions for Schedule D (Form N-40) — Gains and losses from the sale or exchange of capital assets.

General Instructions

Use Schedule D (Form N-40) to report gains and losses from the sale or exchange of capital assets by an estate or trust.

To report sales or exchanges of property other than capital assets, including the sale or exchange of property used in a trade or business and involuntary conversions (other than casualties and thefts), see Schedule D-1 and related instructions.

If property is involuntarily converted because of a casualty or theft, use federal Form 4684, *Casualties and Theft*.

Capital asset.—Each item of property held by the estate or trust (whether or not connected with its trade or business) is a capital asset except:

- Inventoriable assets or property held primarily for sale to customers;
- Depreciable or real property used in a trade or business;
- Certain copyrights, literary, musical, or artistic compositions, letters or memorandums, or similar property;
- Accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of inventoriable assets or property held primarily for sale to customers; and
- Certain Federal publications not purchased at

the public sale price.

You may find additional helpful information in the following publications that are available from the IRS:

Publication 559, *Tax information for Survivors, Executors, and Administrators*.

Publication 544, *Sales and Other Dispositions of Assets*.

Publication 537, *Installment Sales*.

Publication 549, *Condemnations and Business Casualties and Theft*.

Publication 551, *Basis of Assets*.

Short Term or Long Term.—Separate the capital gains and losses according to how long the estate or trust held or owned the property. The holding period for short-term capital gains and losses is 1 year or less. The holding period for long-term capital gains and losses is more than 1 year. Property acquired by a decedent's estate from the decedent and sold or otherwise disposed of within 1 year is considered as held for more than 1 year.

When you figure the length of the period the estate or trust held property, begin counting on the day after the estate or trust acquired the property and include the day the estate or trust disposed of it. Use the trade dates for the date of acquisition and sale of stocks and bonds on an exchange or over-the-counter market.

Section 643(e)(3) election.—For noncash property distributions, a fiduciary may elect to have the estate or trust recognize gain or loss in the same manner as if the distributed property had been sold to the beneficiary at its fair market value (FMV). The distribution deduction is the property's FMV. This election applies to all distributions made by the estate or trust during the tax year, and once made may be revoked only with the consent of the IRS.

Note that section 267 does not allow a deduction for any loss from the sale of property on which a trust makes a section 643(e)(3) election. In addition, when a trust distributes depreciable property, section 1239 applies to deny capital gains treatment on the gain to the trust if the trust makes a section 643(e)(3) election.

Section 644 tax on trusts.—If a trust sells or exchanges property at a gain within 2 years after receiving it from a transferor, a special tax may be due. *Do not include section 644 gains on Schedule D.* The tax is reported separately on Form N-40. For more information see Form N-40 instructions for line 23.

Transfer of appreciated property to a political organization.—If an estate or trust transfers property to a political organization as defined in section 527(e)(1), and if at the time of the transfer the FMV of the property is more than the adjusted basis, treat the transfer as a sale of property on the date of transfer. Report the FMV of the property at the time of transfer as the sale price. Ordinary income or capital gain provisions apply as if a sale had actually occurred. For more information, see section 84 and Publication 559.

Exchange of "like kind" property.—In most cases, no gain or loss is recognized when property held for productive use in a trade or business or for investment is exchanged solely for property of a "like kind" to be held either for productive use in a trade or business or for investment. See section 1031. However, if a trust exchanges "like kind" property with a "related person" (see discussion below), and before 2 years after the date of the last transfer which was part of the exchange the related person disposes of the property, or the trust dis-

poses of the property received in exchange from the related person, then the original exchange will not qualify for nonrecognition. See section 1031(f) for exceptions.

Report these transactions on Schedule D or Schedule D-1 whichever is applicable. If you use Schedule D, identify in column (a) the property disposed of. Enter the date of acquisition in column (b) and the date of exchange in column (c). Write "like kind exchange" in column (d) and enter the adjusted basis in column (e). Enter zero in column (f). Also complete and attach federal Form 8824. See Publication 544 and the Schedule D-1 instructions for more information.

Related persons.—Do not deduct a loss from the sale or exchange of property directly or indirectly between any of the following:

- A grantor and a fiduciary of a trust;
- A fiduciary and a fiduciary or beneficiary of another trust created by the same grantor;
- A fiduciary and a beneficiary of the same trust; or
- A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is owned directly or indirectly by or for the trust or by or for the grantor of the trust.

See Publication 544 for more information.

Items for special treatment.—The following items may require special treatment:

- Wash sales of stock or securities (section 1091).
- Gain or loss on options to buy or sell (section 1234).
- Certain real estate subdivided for sale that may be considered a capital asset (section 1237).
- Gain on disposition of stock in an Interest Charge Domestic International Sales Corporation (section 995(c)).
- Gain on the sale or exchange of stock in certain foreign corporations (section 1248).
- Gain on the sale of qualified reinvested dividends from a qualified public utility. See Publication 550 for details.
- Loss on sale, exchange, or worthlessness of small business stock (section 1244 stock).
- Distributions received from an employee pension, profit-sharing, or stock bonus plan. See Form N-152.

Disposition of market discount bonds.—See section 1276 for rules on the disposition of any market discount bonds that were issued after July 18, 1984.

Section 1256 contracts and straddles.—See the instructions for federal Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles*, to report gains or losses from section 1256 contracts or straddles that the estate or trust held during the tax year. For more information, see Publication 550 and sections 1092 and 263(g).

Line-by-Line Instructions

Line 1. Short-term capital gains and losses.—Enter all sales of stocks, bonds, etc.

Redemption of stock to pay death taxes.—If stock is redeemed under the provision of section 303, list and identify it on line 7 and give the name of the decedent and the district office where the estate tax or GST tax return was filed.

If you are reporting capital gain from a lump-sum distribution, see the instruction for Form N-152 for information on death benefit exclusion and the Federal estate tax.

Column (d). Gross sales price.—Enter either the gross sales price or the net sales price from the sale. On sales of stocks and bonds, report the gross amount as reported to the fiduciary by the fiduciary's broker on federal Form 1099-B or similar statement. However, if the broker advised the fiduciary that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that net amount in column (d).

Column (e). Cost or other basis, as adjusted, plus expense of sale.—Enter the cost or adjusted basis of the property sold or exchanged, plus any expense of sale, such as broker's fees, commissions, etc. The basis of property acquired from or passing from a decedent is generally the FMV at the date of death. For more information, see Publication 551, Publication 559, and section 1014.

For any debt instrument having original issue discount issued after July 1, 1982, the basis is increased by the amount of original issue discount that has been included in gross income. See Publication 550.

Attach an explanation if the basis used is other than the actual cash cost of the property.

Lines 2 and 8. Installment sales.—If the estate or trust sold property at a gain this year and will receive a payment in a later tax year, use the installment method and file federal Form 6252, Installment Sale Income, unless you elect not to.

Also use federal Form 6252 to report any payment received in 1996 from a sale made in an earlier year that was reported on the installment method.

If the estate or trust elects not to use the installment method, report the full amount of the gain on a timely filed return (including extensions).

If the estate or trust files federal Form 6252, enter on Schedule D (Form N-40), line 2, the short-term capital gain from installment sales from federal Form 6252. Enter on Schedule D (Form N-40), line 8, the long-term capital gain from installment sales from federal Form 6252.

See Publications 537 and 559 for more information.

Line 7. Long-term capital gains and losses.—Enter all sales of stocks, bonds, etc.

Attach an explanation if the basis used is other than the actual cash cost of the property.

Line 10. Capital gain distributions.—Enter any amounts shown on federal Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains, that represent the estate's or trust's share of the undistributed capital gains of a regulated investment company.

Line 15, column (a). Beneficiaries' net short-term capital gain or loss.—Enter the amount of net short-term capital gain or loss allocable to the beneficiary or beneficiaries. Except in the final year, include only those short-term capital losses that are taken into account in determining the amount of gain from the sale or exchange of capital assets that is paid, credited, or required to be distributed to any beneficiary during the tax year. See Publication 559 and Regulations section 1.643(a)-3 for more information about allocation of capital gains and losses.

Except in the final year, if the losses from the sale or exchange of capital assets are more than the gains, all of the losses are allocated to the fiduciary and none are allocated to the beneficiaries.

Line 15, column (b). Fiduciary's net short-

term capital gain or loss.—Enter the amount of the net short-term capital gain or loss allocable to the fiduciary. Include any capital gain paid or permanently set aside for the charitable purpose specified in section 642(c).

Line 15, column (c). Total.—Enter the total of the amounts entered in columns (a) and (b). The amount in column (c) should be the same as the amount on line 6.

Line 16. Net long-term capital gain or loss.—Treat the net long-term capital gain or loss on line 16 in the same manner as the net short-term capital gain or loss on line 15.

Part IV. Computation of capital loss limitation.—If the sum of all the capital losses is more than the sum of all the capital gains, then these capital losses are allowed as a deduction only to the extent of the smaller of the net loss or \$3,000.

Part V. Computation of capital loss carryovers from 1996 to 1997.—Complete Part V to figure the capital loss carryover. A capital loss carryover may be carried forward indefinitely. Capital losses keep their character as either short-term or long-term when carried over to the following year. To the extent the capital loss subject to the limitation is deducted from ordinary income, consider the net short-term capital loss as deducted first. If this is the final year of the estate or trust, also enter on line 9c, Schedule K-1.

For more information, see Publication 544 and Publication 550.

Part VI. Tax Computation Using Maximum Capital Gains Rate.—

Line 37.—If the estate or trust received capital gains that were derived from income in respect of a decedent, and a section 691(c)(4) deduction was claimed, then line 37 must be reduced by the portion of the section 691(c)(4) deduction claimed on Form N-40, line 19.

Line 44.—To compute the regular tax, see the instructions for Form N-40, line 23.

Line 45.—If the tax, using the Maximum Capital Gains Rate (line 43), is less than the regular tax (line 44), then enter the amount from line 45 on Form N-40, line 23, and check the "Schedule D" box.

Schedule E — Page 3 Non-refundable credits.

Line 1. Credit allowed for taxes paid to a state or foreign country by a resident estate or trust.—If a resident estate or trust derived income from sources without Hawaii and paid a net income tax to a state or foreign country, a credit may be claimed against the Hawaii income tax on page 1, line 24. A credit is allowable against the Hawaii income tax only if the tax paid to a state or foreign country was based on net income of the same taxable year and only if the income taxed by the state or foreign country was derived from sources without Hawaii. Intangible personal property of a resident estate or trust has a situs within Hawaii, therefore income from such property is derived from within and not from without Hawaii and no credit may be allowed for taxes paid to a state or foreign country based on such income. (However, in the rare case of a separate business situs there may be an exception to this rule.) To obtain a credit against the Hawaii tax, a copy of the return filed with a state or foreign country must be furnished as well as a receipt or other evidence to substantiate payment of the tax. If any taxes paid are at any time refunded, the Hawaii State Tax

Collector must be notified promptly of such refund. The Hawaii Income Tax Law allows no credit to a nonresident estate or trust for the taxes paid to a state or foreign country. **Limitations of credit—see Department of Taxation Rules.**

Line 2. Energy Conservation Tax Credit.—Each resident taxpayer who files an income tax return for 1996 may claim a tax credit for a solar or wind energy system or heat pump installed and placed in service in Hawaii in 1996. Additions to existing systems (e.g., additional solar energy panels) and systems for a second home qualify for this credit. The cost of repairs to existing systems, however, do not qualify for this credit. The tax credit shall apply only to the actual cost of the solar or wind energy system or heat pump, including their accessories and installation, and shall not include the cost of consumer incentive premiums unrelated to the operation of the system or offered with the sale of the system or heat pump (such as "free gifts", offers to pay electricity bills, or rebates).

The tax credit may be claimed for the following energy conservation systems installed and placed in service after 12/31/89 (12/31/90 for ice storage systems), but before 1/1/99:

Type of Energy Conservation System	Tax Credit Rate
1. Wind energy systems	20% of the actual cost of the system.
2. Solar energy systems	
a. New and existing single family residential buildings.	The lesser of 35% of the actual cost of the system or \$1,750.
b. New and existing multi-unit buildings used primarily for residential purposes.	Per building unit: The lesser of 35% of each unit's actual cost of the system or \$350.
c. New and existing hotel, commercial and industrial facilities.	35% of the actual cost of the system.
3. Heat pumps	
a. New and existing single family residential buildings.	The lesser of 20% of the actual cost of the heat pump or \$400.
b. New and existing multi-unit buildings used primarily for residential purposes.	Per building unit: The lesser of 20% of each unit's actual cost of the heat pump or \$200.
c. New and existing hotel, commercial and industrial facilities.	20% of the actual cost of the heat pump.
4. Ice storage systems	50% of the actual cost of the system.

Tax credits that exceed your income tax liability are not refunded but may be used as a credit against your income tax liability in subsequent years until exhausted.

A fiduciary is required to prepare an Information Statement, Form N-157A, for each individual beneficiary in order that the prorated amount of the fiduciary's tax credit may be claimed by the individual taxpayer on Form N-157.

For more information, see Forms N-157 and N-157A.

Line 3. Enterprise Zone Tax Credit.—A qualified enterprise zone business is eligible to claim a credit for a percentage of taxes due the State attributable to the conduct of business within a zone and a percentage of the amount of unemploy-

ment insurance premiums paid based on the payroll of employees employed at the business firm establishments in the zone. The applicable percentage is 80% the first year; 70% the second year; 60% the third year; 50% the fourth year; 40% the fifth year; 30% the sixth year; and 20% the seventh year. This credit is not refundable and any unused credit may NOT be carried forward. Attach Form N-756, Enterprise Zone Tax Credit, to support your claim for this credit.

Line 4. Low-Income Housing Tax Credit.—Hawaii's low-income housing tax credit is equal to 30% of the federal credit for qualified buildings located within the State of Hawaii. The federal credit must be claimed in order to claim the Hawaii credit. Attach Form N-586, Hawaii Low-Income Housing Tax Credit, to the income tax return on which the credit is claimed. Enter the fiduciary's share on Schedule E, line 4.

Contact the Housing Finance Development Corporation for qualifying requirements and further information.

Line 5. Credit For Employment of Vocational Rehabilitation Referrals.—The amount of the tax credit for the taxable year shall be equal to 20% of the qualified first-year wages for that year. The amount of the qualified first-year wages which may be taken into account with respect to any individual shall not exceed \$6,000 per year.

"Qualified wages" means the wages paid or incurred by the employer during the taxable year to an individual who is a vocational rehabilitation referral and more than one-half of the wages paid or incurred for such an individual is for services performed in a trade or business.

"Qualified first-year wages" means, with respect to any individual, qualified wages attributable to service rendered during the one-year period beginning with the day the individual begins work for the employer.

The credit allowed shall be claimed against net income tax liability for the taxable year. A tax credit which exceeds the taxpayer's income tax liability may be used as a credit against the taxpayer's income tax liability in subsequent years until exhausted.

The deduction for wages expense must be reduced by the amount of the credit claimed.

Refer to Form N-884 for further information.

Instructions for Schedule J (Form N-40) Trust Allocation of an Accumulated Distribution

Refer to federal instructions for Schedule J, Form 1041.

Instructions for Schedule K-1 (Form N-40) Beneficiary's Share of Income, Deductions, Credits, Etc.

Important Notes

For Form N-11 filers, if your federal Schedule K-1 (Form 1041) and Hawaii Schedule K-1 (Form N-40) are different, the necessary adjustments are to be computed on the Hawaii Additions Worksheet and the Hawaii Subtractions Worksheet in the Form N-11 Instructions.

All referenced worksheets are contained in the N-11/N-12 Instructions.

General Instruction

Purpose of form.—The fiduciary uses Schedule

K-1 (Form N-40) to report the beneficiary's share of income, deductions, and credits from a trust or decedent's estate.

Who must file.—The fiduciary (or one of the joint fiduciaries) must file Schedule K-1. A copy of each beneficiary's Schedule K-1 is attached to the Form N-40 filed with the Department of Taxation and each beneficiary is given a copy of his or her respective Schedule K-1. One copy of each Schedule K-1 must be retained for the fiduciary's records.

Beneficiary's identifying number.—As a payer of income, you are required to request and provide a proper identifying number for each recipient of income. Individuals and business recipients are responsible for giving you their taxpayer identification numbers upon request.

Beneficiary's income.—If no special computations are required, use the following instructions to compute the beneficiary's income from the estate or trust. In other cases, see Publication 559 and sections 652, 662, and 663, and related regulations. For example, special computations are required for capital gains and losses or a charitable deduction. In addition, the terms of the governing instrument may require different computations.

Income.—The beneficiary must include in gross income the smaller of: (1) the amounts paid, credited, or required to be distributed; or (2) the proportionate share of distributable net income, reduced in either case by the share of distributable tax-exempt income minus the allocable expense not allowable as a deduction on Form N-40.

Character of income.—The beneficiary's income is considered to have the same proportion of each class of items entering into the computation of DNI that the total of each class has to the DNI (for example, half dividends and half interest if the entity's income is half dividends and half interest).

Allocation of deductions.—Generally, items of deduction that enter into the computation of DNI are to be allocated among the items of income to the extent such allocation is not inconsistent with the rules set out in section 469 and the regulations thereunder, relating to passive activity loss limitations, in the following order.

First, all deductions directly attributable to one class of income are deducted from that income. For example, rental expenses, to the extent allowable, are deducted from rental income.

Second, deductions which are not directly attributable to one class of income, such as fiduciary fees, may be allocated to any class of income, as long as a reasonable portion is allocated to any tax-exempt income.

Finally, any excess deductions which are directly attributable to a class of income may be allocated to another class of income. In no case can excess deductions from a passive activity be allocated to income from a non-passive activity, or to portfolio income earned by the estate or trust. Excess deductions attributable to tax-exempt income cannot offset any other class of income.

In no case can deductions be allocated to an item of income that is not included in the computation of DNI, or attributable to corpus.

Except for the final year and for depreciation or depletion allocations in excess of income, you may not show any negative amounts for any class of income because the beneficiary generally may not claim losses or deductions from the estate or trust.

Allocation of credits.—In general, the estate or trust or the beneficiaries may claim applicable

tax credits according to how the income is divided.

Past years.—Do not include in the beneficiary's income amounts deducted on Form N-40 for an earlier year that were credited or required to be distributed in that earlier year.

Beneficiary's tax year.—The beneficiary's income from the estate or trust must be included in the beneficiary's tax year during which the tax year of the estate or trust ends. See Publication 559 for more information including the effect of the death of a beneficiary during the tax year of the estate or trust.

Line-by-Line Instructions

Line 1. Interest.—Enter the beneficiary's share of the taxable interest income.

Line 2. Dividends.—Enter the beneficiary's share of dividend income.

Line 3a. Net short-term capital gain.—Enter the beneficiary's share of the net short-term capital gain from Schedule D (Form N-40), line 15, column (a). Do not enter a loss for any year before the final year of the estate or trust. If for the final year there is a capital loss carryover, enter on line 9b, the beneficiary's share of short-term capital loss carryover as a loss in parentheses. However, if the beneficiary is a corporation, enter the beneficiary's share of all carryover capital losses in parentheses. See federal Publication 559 and section 642(h) and related regulations for more information.

Line 3b. Net long-term capital gain.—Enter the beneficiary's share of the net long-term capital gain from Schedule D (Form N-40), line 16, column (a). Do not enter a loss for any year before the final year of the estate or trust. If for the final year there is a capital loss carryover, enter on line 9c, the beneficiary's share of the long-term capital loss carryover as a loss in parentheses. (If the beneficiary is a corporation, see the instructions for line 3a.) See Publication 559, section 642(h) and related regulations for more information.

Gains, or losses, from the complete, or partial, disposition of a rental, rental real estate, or trade or business activity that is a passive activity, must be shown as an attachment to Schedule K-1.

Line 4a. Business income and other non-passive income.—Enter the beneficiary's share of annuities, royalties, or any other income, before any directly apportionable deductions, that is NOT subject to any passive activity loss limitation rules at the beneficiary level. Use line 5a to report income items that could be subject to the passive activity rules at the beneficiary's level.

Lines 4b and 5b. Depreciation (including cost recovery).—Enter the beneficiary's share of the depreciation deductions attributable to each activity reported on lines 4a and 5a. See the instructions for line 4 on page 4 for a discussion of how the depreciation deduction is apportioned between the beneficiaries and the estate or trust.

Note: An estate or trust cannot make an election under section 179 to expense certain depreciable business assets.

Lines 4c and 5c. Depletion.—Enter the beneficiary's share of the depletion deduction under section 611 attributable to each activity reported on lines 4a and 5a. See the instructions for line 4 on page 4 for a discussion of how the depletion deduction is apportioned between the beneficiaries and the estate or trust.

Lines 4d and 5d. Amortization.—Itemize the beneficiary's share of the amortization deductions

attributable to each activity reported on lines 4a and 5a. Divide the amortization deductions between the fiduciary and the beneficiaries in the same way that the depreciation and depletion deductions are divided.

Lines 5a through 5d.—Caution: *The limitations on passive activity losses and credits under section 469 apply to estates and trusts. Estates and trusts that distribute income to beneficiaries are allowed to allocate depreciation, depletion, and amortization deductions to the beneficiaries. These deductions are referred to as "directly allocable deductions."*

Any directly allocable deduction, such as depreciation, is treated by the beneficiary as having been incurred in the same activity as incurred by the trust or estate. However, the character of such deduction may be determined as if the beneficiary incurred the deduction directly.

To assist the beneficiary in computing any applicable passive activity loss limitations, also attach a separate schedule showing the beneficiary's share of income derived from: (a) rental; (b) rental real estate; and (c) business activities.

If there is more than one activity, one or more of which is a passive activity, income and deductions are to be shown separately for each activity on an attached schedule.

Line 6. Estate tax deduction. (including GST taxes)—If the distribution deduction consists of any income in respect of a decedent, and the estate or trust was allowed a deduction for the Hawaii Estate Tax paid attributable to such income (see the line 19 instructions on page 6), then the beneficiary is allowed an estate tax deduction in proportion to his or her share of the distribution that consists of such income. For an example of the computation see federal Regulations section 1.691(c)-2. Figure the computation on a separate sheet and attach it to the return. As a reminder, only Hawaii Estate Tax, not federal estate tax, is allowed as a deduction.

Line 7. Other net income taxes.—List on a separate sheet the beneficiary's share of the applicable net income taxes paid or accrued to another state or foreign country. Identify and include the various sources for the beneficiary's credit.

Line 8a. Capital Goods Excise Tax Credit.—Enter the beneficiary's share of the cost of property qualifying for the Capital Goods Excise Tax Credit. Also complete Form N-312A for each beneficiary.

Line 8b. Low-Income Housing Tax Credit.—Enter the beneficiary's share of the Low-Income Housing Tax Credit. Also complete Form N-586 for each beneficiary.

Line 9a. Excess deductions on termination.—If this is the final return and there are excess deductions on termination or a NOL carryover (see instruction for "Line 17. Adjusted total income or (loss).—"), enter the beneficiary's share of the excess deductions on line 9a.

(a) **Excess Deductions.** Excess deductions on termination occur only during the last taxable year of the estate or trust when the total deductions (other than the deductions allowed under section 642(b) (relating to the exemption amount) or section 642(c) (relating to the charitable contributions)) are greater than the gross income during that tax year. Figure the deductions on a separate sheet and attach it to the form.

Only the beneficiary of an estate or trust that succeeds to its property is allowed to deduct that entity's excess deductions on termination. A beneficiary who does not have enough income in that year to absorb the entire deduction may not carry the balance over to any succeeding year. An individual beneficiary must be able to itemize deductions in order to claim the excess deductions in determining taxable income.

Lines 9b and 9c. Unused capital loss carryover.—Upon termination of the trust or decedent's estate, the beneficiary succeeding to the property is allowed as a deduction any unused capital loss carryover under section 1212. If the estate or trust incurs capital losses in the final year, use Part V of Schedule D (Form N-40) to compute the amount of capital loss carryover to be allocated to the beneficiary.

Lines 9d and 9e. Net operating loss (NOL) carryover.—Generally, a deduction based upon a NOL carryover is not available to a beneficiary as an excess deduction. However, if the last tax year of the estate or trust is also the last year in which a NOL carryover may be taken (see section 172(b)), then the NOL carryover is considered an excess deduction on the termination of the entity to the extent it is not absorbed by the estate or trust during its final tax year. For more information, see Publication 559, section 642(h), and the related regulations.

Upon termination of an estate or trust, a beneficiary succeeding to its property is allowed to deduct any amount of unused NOL carryover. Enter the unused carryover amount and write "NOL CARRY-OVER" (see line 9a instructions) to the left of the figure.

Line 10. Other.—Itemize on line 10, or on a separate sheet, the beneficiary's tax information for which there is no other line on Schedule K-1. This includes the allocable share, if any, of:

- Tax-exempt interest realized by the trust (including exempt-interest dividends received as a shareholder in a mutual fund or other regulated investment company);
- Payment of estimated tax to be credited to the beneficiary, including any Hawaii income taxes withheld upon the sale of Hawaii real property by a nonresident estate or trust if the sale is taxable at the beneficiary level. (A copy of Schedule K-1 (Form N-40) must be attached to beneficiary's return to substantiate claim.)
- Nontaxable dividends;
- Investment income (section 163(d));
- Energy conservation tax credit;
- Enterprise zone tax credit;
- Credit for employment of vocational rehabilitation referrals;
- Credit for tax deemed paid on undistributed capital gains of regulated investment companies;
- Fuel tax credit for commercial fishers;
- The information a beneficiary will need to compute any recapture taxes; and

Note: *Upon termination of an estate or trust, any suspended passive activity losses (PALs) relating to an interest in a passive activity cannot be distributed to the beneficiary. Instead, the basis in such activity is increased by the amount of any PALs allocable to the interest, and no losses are allowed as a deduction on the estate's or trust's Form N-40.*

Schedule T – Page 4 Allocation of Estimated Tax Payments to Beneficiaries

General Instructions

A trust or a decedent's estate may elect to have any part of its estimated tax payments treated as made by a beneficiary or beneficiaries. The fiduciary fills out Schedule T to make the election.

When To File

For the election to be valid, a trust or decedent's estate must file the completed Schedule T with the original Form N-40. The election will not be recognized if it is made on an amended return.

Period Covered

The election is for the period covered on the original Form N-40 it is submitted with.

Line-By-Line Instructions

Line 1

Enter the amount of estimated tax payments made by the trust or decedent's estate that the fiduciary elects to treat as a payment made by the beneficiaries. This amount is treated as if paid or credited to the beneficiaries on the last day of the tax year of the trust or decedent's estate. Be sure to include it on Schedule B, line 12.

Line 2

Column (b) – Beneficiary's name and address. – Group the beneficiaries to whom you are allocating estimated tax payments into two categories. First, list all the individual beneficiaries (those who have social security numbers (SSNs)). Then, list all the other beneficiaries.

Column (c) – Beneficiary's identifying number. – For each beneficiary, enter the SSN (for individuals) or employer identification number (EIN) (for all other entities). Failure to enter a valid SSN or EIN may cause a delay in processing and could result in penalties being imposed on the beneficiary. For those beneficiaries who file a joint return, you can assist the Department of Taxation in crediting the proper account by also providing the SSN, if known, of the beneficiary's spouse. However, this is an optional entry.

Column (d) – Amount of estimated tax payment allocated to beneficiary. – For each beneficiary, also enter this amount on Schedule K-1 (Form N-40), line 10a.

Column (e) – Proration percentage. – For each listed beneficiary, divide the amount shown in column (d) by the amount shown on line 1 and enter the result as a percentage.

Line 3

If you are allocating a payment of estimated taxes to more than 20 beneficiaries, list the additional beneficiaries on an attached sheet that follows the format of line 2. Enter on line 3 the total from the attached sheet(s).

Line 4

Total the amounts in line 2, column (d), and line 3. This amount must equal to line 1.

B—SPECIFIC INSTRUCTIONS FOR NONRESIDENT ESTATES AND TRUSTS

In general, the instructions for resident estates and trusts apply. However, lines 1 through 7 will include only gross income from property owned and other sources in Hawaii.

No deduction may be had for interest paid or accrued or indebtedness incurred or continued to

purchase or carry property owned outside Hawaii or to carry on trade or business outside Hawaii. Losses from property owned outside Hawaii and from other sources outside Hawaii shall not be deducted. Likewise, other deductions connected with income from sources outside Hawaii shall not

be allowed. Though an amount otherwise would be allowable as a deduction under section 212 (relating to expenses for the production of income), it is not allowable to the extent allocable to income from sources outside Hawaii.